

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 96-0370
Gross Income Tax
For The Tax Period: 1992**

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ISSUES

I. **Gross Income Tax – Bad Debt Deduction**

Authority: IC 6-2.1-4-2, IC 6-2.5-6-9

The Taxpayer protests the Department's assessment for the amount claimed as a bad debt expense.

II. **Tax Administration – Penalty**

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2(c).

The Taxpayer protests the Department's assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer filed a consolidated return for the fiscal year of 1992. The Taxpayer and its affiliates are involved in the businesses of manufacturing, publishing, services, and the earning of royalties. The Taxpayer entered into a promissory note with Corporation A in partial consideration for the sale of Corporation B's capital stock. The total net proceeds to be reported at the time of collection was less than the original promissory note. For federal purposes, the Taxpayer reported the entire transaction using the installment method provided by the Internal

Revenue Code. The Taxpayer deducted the amount as a bad debt expense to reduce its Indiana gross receipts. More facts will be supplied as necessary.

I. **Gross Income Tax: Bad Debt Deduction**

DISCUSSION

The Taxpayer claimed a bad debt expense in the amount of the expenses it sustained as a result of an indemnity clause. The bad debt expense was claimed as a reduction of reported taxable gross receipts only and was not claimed as a bad debt expense on its federal 1120 because the Taxpayer used the accrual basis to deduct it from its gross income.

The Taxpayer contends that it is erroneous to deny them a bad debt deduction from their gross income on their Indiana return because they originally paid gross income tax on the full amount of the promissory note and did not receive that full amount. The Taxpayer states that because they report their gross income on an accrual basis, they are entitled to claim a bad debt expense under IC 6-2.1-4-2. Pursuant to IC 6-2.1-4-2: "Each taxable year, a taxpayer that reports his gross income on an accrual basis is entitled to deduct bad debts from his gross income in the same manner provided in IC 6-2.5-6-9."

(a) In determining the amount of state gross retail and use taxes which he must remit under section 7 of this chapter, a retail merchant shall deduct from his gross retail income from retail transactions made during a particular reporting period, and amount equal to his receivables which:

- (1) resulted from retail transactions in which the retail merchant did not collect the state gross retail or use tax from the purchaser;
- (2) resulted from retail transactions on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and
- (3) were written off as an uncollectible debt for federal tax purposes during the particular reporting period.

(b) If a retail merchant deducts a receivable under subsection (a) and subsequently collects that receivable, then the retail merchant shall include the amount collected as part of his gross retail income from retail transactions for the particular reporting period in which he makes the collection.

IC 6-2.1-4-2

However, the Taxpayer did not write off the loss as an uncollectible debt for federal tax purposes. The Taxpayer states that the reporting methodology does not alter the fact that the receivable is no longer collectible and has been reflected as such for federal tax purposes. IC 6-2.5-6-9 clearly states that in order to deduct the amount from gross income it must be "written off as an uncollectible debt for federal tax purposes."

Assuming *arguendo*, that the Taxpayer could report the deduction on their Indiana return, they have not shown that the expense reported qualifies as a bad debt. According to the audit report, the Taxpayer assumed certain indemnity expenses against the gross amount of the note as part of the sales agreement. Therefore, the reduction of the note payments did not originate from an unexpected default on the payment, but rather, from the pre-arranged agreement of the Taxpayer.

FINDING

The Taxpayer's protest is respectfully denied.

I. Tax Administration: Penalty

DISCUSSION

IC 6-8.1-10-2.1(d) allows a penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Also, 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. The Department finds that the Taxpayer demonstrated reasonable cause for their failure to pay tax.

FINDING

The Taxpayer's protest of the penalty is sustained.